Section 13
Guidance on Section 199 – Income Attributable to Manufacturing Activities

Overview:
On January 19, 2005, the Treasury Department and IRS issued Notice 2005-14 pursuant to section 199 of the Internal Revenue Code regarding the deduction relating to income attributable to domestic production activities. The Notice provides interim guidance on which taxpayers may rely until proposed regulations are issued.

Background:
On October 22, 2004, President Bush signed into law the American Jobs Creation Act, which included a tax benefit for certain domestic production activities.

When is the provision effective?
The provision is effective for taxable years beginning after December 31, 2004.

How is the deduction computed?
For 2005, the deduction equals three percent of the lesser of: (a) taxable income derived from a qualified production activity; or (b) taxable income, for the taxable year. However, the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. In 2010, when the deduction is fully phased-in, the three percent rate will have increased to nine percent.

What constitutes a "qualified production activity?"
The following activities are qualified production activities:

- The manufacture, production, growth, or extraction in whole or significant part in the United States of tangible personal property (e.g., clothing, goods, and food), software development, or music recordings;
- Film production (with exclusions provided in the statute), provided at least 50 percent of the total compensation relating to the production of the film is compensation for specified production services performed in the United States;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; or
- Engineering and architectural services performed in the United States and relating to construction of real property.

How is taxable income derived from the manufacture, production, growth, or extraction of tangible personal property determined?

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Gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of tangible personal property manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States are reduced by allocable costs and deductions.

What constitutes "in significant part"?
Property will be treated as manufactured by the taxpayer "in significant part" if: based on all of the taxpayer's facts and circumstances, the manufacturing, production, growth, or extraction activity performed by the taxpayer in the United States is substantial in nature; or the labor and overhead costs incurred by the taxpayer in the United States for the manufacture, production, growth, and extraction of the property are at least twenty percent of the taxpayer's total cost for the property.

For example, assume that a taxpayer purchases a small motor and various parts and materials for $75 and incurs $25 in labor costs at its factory in the United States to fabricate a plastic car body from the materials and to assemble a toy car. The taxpayer also incurs packaging, selling and other costs of $2 and sells the toy car in 2005 for $112. The toy car will be treated as manufactured by the taxpayer "in significant part" because the taxpayer's labor costs are more than twenty percent of the taxpayer's total cost for the toy car ($25 / ($25 + $75) = 25%). The taxpayer's domestic production activities deduction will be three percent of the taxpayer's $10 profit on the toy car or 30¢ (3% * ($112-$75-$25-$2). If the sale occurred in 2010, when the deduction is fully phased in, the deduction would be nine percent of the taxpayer's $10 profit on the car or 90¢ (9% * ($112-$75-$25-$2).

The domestic production activities deduction provides a tax savings on profits from production activities in the United States. If a taxpayer has satisfied the "significant part" test and the other requirements for the deduction, the deduction is a portion of the taxpayer's profits from domestic production and increases as those profits increase.

Are packaging, design, and development activities taken into account in applying the "significant part" test for tangible personal property?
Packaging, repackaging, labeling, and minor assembly operations are not taken into account for purposes of the "significant part" test. Thus, a taxpayer cannot qualify for the domestic production activities deduction if the taxpayer's only activities in the United States are packaging and labeling property produced outside the United States.

Design and development activities also do not constitute manufacturing activities for purposes of the "significant part" test for tangible personal property because these activities produce an intangible asset (the design) rather than tangible personal property.

Is a contract manufacturer eligible for the deduction?
If one taxpayer performs manufacturing activities for another taxpayer, only the taxpayer with the benefits and burdens of ownership of the tangible personal property during the manufacturing process will be treated as the manufacturer. As a result, only one taxpayer will be entitled to the deduction with respect to a manufacturing activity performed with respect to an item of tangible personal property.

Are there any safe harbor or de minimis rules?
Several safe harbor and de minimis rules will reduce computational and recordkeeping burdens, including:

- Simplified formulas to assist small taxpayers in determining taxable income from qualifying activities;
- De minimis rules to avoid the difficulty of making revenue and expense allocations as a result of small amounts of income from non-qualifying activities; and
- Simplified formulas for determining a taxpayer's W-2 wages.

What construction activities qualify for the deduction?
Qualifying activities include construction and substantial renovation of real property, including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.

The statute does not provide that qualifying gross receipts for construction activities must be derived from a lease, rental, license, sale, exchange, or other disposition of the property. As a result, a taxpayer engaged in construction activities may qualify for the deduction even if the taxpayer does not have the benefits and burdens of ownership of the property being constructed. Therefore, more than one taxpayer may be regarded as constructing real property with respect to the same activity and the same construction project. For example, a general contractor and a subcontractor may both be engaged in construction activities with respect to the installation of a roof on a new building. Each taxpayer's benefit will be a percentage of its profit on its work with respect to the installation of the roof.

Gross receipts derived from the rental of real property that the taxpayer constructs are not derived from construction, but rather are income for the use or forbearance of the property.

As a result, rental income for real property is not eligible for the qualified production activities deduction. Gain on the later sale of the property may qualify for the deduction if all other requirements are satisfied.

Does the preparation of food and beverages qualify for the deduction?

Food and beverages prepared at a retail establishment do not qualify for the deduction. A retail establishment is real property used in the trade or business of selling food or beverages to the public if retail sales occur at the facility. For example, a restaurant at which food and beverages are prepared, sold, and served to customers would be a retail establishment. However, the Treasury Department and IRS recognize that some retail establishments prepare food and beverages for both wholesale and retail sale. As a result, the Notice provides that even if a taxpayer's facility is a retail establishment,
food or beverages prepared at the facility and sold at wholesale are not considered prepared at a retail establishment and the taxable income related to the wholesale transactions is therefore eligible for the deduction.

How does a taxpayer compute W-2 wages for purposes of the wage limitation?
There are three alternative methods for computing W-2 wages. The first method permits a taxpayer to use the lesser of the W-2 wages reported in Box 1 or Box 5 of Forms W-2. Alternatively, there are two methods that, although more complex, provide a more precise determination of W-2 wages. The Notice provides that the W-2 wages are those wages of common law employees of the taxpayer.

What income derived from computer software is eligible for the deduction?
In general, income from a lease, rental, license, sale, exchange, or other disposition of software developed in the United States qualifies for the deduction, regardless of whether the customer purchases the software off the shelf or takes delivery of the software by downloading the software from the Internet. Computer software is not limited to software for computers and includes, for example, video game software. However, subject to certain de minimis rules, the following income does not qualify for the deduction because the income is attributable to the provision of a service and is not derived from a lease, rental, license, sale, exchange, or other disposition of the software:

- Fees for on-line use of software;
- Fees for customer support with respect to computer software;
- On-line services;
- Fees for telephone services provided in part through use of software;
- Fees for playing computer games on-line; and
- Provider-controlled online access services.

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How does a partnership or S corporation compute the section 199 deduction?
The deduction attributable to the qualifying production activities of a partnership or S corporation (pass-through entity) is determined at the partner or shareholder (partner) level. As a result, each partner must compute its deduction separately. In general, each partner is allocated its share of items (including items of income, gain, loss, and deduction) allocable or attributable to qualifying production activities of the pass-through entity, along with any other items of income, gain, loss, deduction or credit of the pass-through entity. The partner must aggregate its share of the items allocable or attributable to the pass-through entity's qualified production activities, any expenses incurred by the partner directly that are allocable to the pass-through entity's qualified production activities,

and items allocable or attributable to the partner's other qualified production activities to determine its qualified production activities deduction for the taxable year. Simplifying rules are provided for certain small partnerships.

How does a taxpayer allocate cost of goods sold and other deductions to qualifying production activities?
If a taxpayer cannot specifically identify the cost of goods sold, the taxpayer may use a reasonable method to determine the cost of goods sold related to the taxpayer's qualifying production activities. If the taxpayer uses a method to determine the allocable portion of its gross receipts derived from qualifying production activities, the taxpayer must use the same method for purposes of determining the allocable cost of goods sold.

Two methods are provided for allocating deductions (other than cost of goods sold) to qualified production activities:

- Method 1, which is available to all taxpayers and generally follows existing rules applicable to taxpayers required to determine taxable income from within and outside the United States; and
- Method 2, which is available to taxpayers with average annual gross receipts (over the three prior years) of $25,000,000 or less, provides a simplified formula that allocates deductions based on the ratio of the taxpayer's receipts derived from qualifying production activities as compared to the taxpayer's receipts from all sources.

Lastly, the Notice provides a third method for small taxpayers that allocates both cost of goods sold and all other deductions based on the same ratio applicable to Method 2.

This third method is available to taxpayers with average annual gross receipts of

$5,000,000 or less and certain other small taxpayers permitted to use the cash method of accounting.

Will the Treasury Department and the IRS issue additional guidance regarding the deduction?
The Treasury Department and IRS anticipate that forthcoming proposed regulations will incorporate the rules set forth in the Notice.